THE COTTON FUTURES ACT

The passage, last August, of the United States Cotton Futures act, also known as the Smith-Lever law,[1] may be viewed as the culmination of a prolonged legislative movement covering a period of over twenty years, directed against the cotton exchanges of the country—particularly the New York Cotton Exchange.[2] The law went into full operation on February 18, 1915. Although the act is not perfect, it is on the whole more practical and sensible than any of the countless number of bills that had been proposed in previous years, and when amended, as it undoubtedly will be in the near future, the law should prove one of the most beneficial legislative acts ever passed by the American Congress. The act is designed to regulate the business of trading in contracts for the future delivery of cotton. It concerns the distribution and sale of our enormous cotton crop, valued at nearly one thousand million dollars a year, and indirectly affects the prosperity of many millions of people who in one way or another take part in the production of cotton, in its exportation to foreign countries, and in its conversion into manufactured cotton goods. In brief, the law seeks to place the sale and distribution of our cotton crop on an honest basis, to eliminate abuses, the existence of which has redounded to the benefit of a few, and to standardize the entire cotton business generally.

The title of the law declares it to be "an act to tax the privilege of dealing on exchanges, boards of trade, and similar places, in contracts of sale of cotton for future delivery," but a reading of the law clearly establishes the fact that the tax, amounting to two cents a pound, is imposed only in cases where the business transacted does not conform to certain requirements specified in the act and to the regulations issued thereunder by the Secretary of

[1] 38 U.S. Statutes at Large, p. 693.

[2] Organized dealing in cotton futures in the United States is practically limited to the New York Cotton Exchange, organized on September 7, 1870, and incorporated under the laws of the state of New York in April, 1871; and the New Orleans Cotton Exchange, which was formed in January, 1871.

Agriculture and the Secretary of the Treasury. In other words, the tax is a penal tax, and is applicable only in the event that the methods and practices prescribed by the federal government are not complied with. A cotton exchange, to exempt its transactions from taxation, must revise the by-laws and rules governing its methods of doing business by providing among other things, the following:

1. The cotton dealt in and deliverable upon a contract for future delivery shall be of or within the grades of the official standards promulgated by the Secretary of Agriculture. The character of cotton not deliverable is strictly defined, and tender of a staple shorter than seven-eighths of an inch is prohibited.

2. The relative differences in value of the various grades of cotton compared with middling, as a basis, must be determined by taking the average of quotations for each of the grades obtained from certain designated markets, said quotations being based upon actual transactions.

The law also provides that the seller of the cotton shall furnish to the buyer a written notice or certificate stating the grade of each individual bale he expects to deliver, identifying the same by marks and numbers. In case a dispute arises between buyer and seller as to the quality or grade of the tendered cotton or the length of the staple, either party may refer the question to the Secretary of Agriculture for determination.

Another feature of the law is the imposition of a tax of two cents a pound on all cable messages transmitted for the purchase or sale of American cotton upon foreign exchanges whose standard grades and rules of operation do not conform to the requirements specified in the act as applying to exchanges doing business within the United States. It is this provision which has called forth most of the adverse criticism directed against the new law. The tax is prohibitive, and has consequently operated as an absolute stop to transactions on the Liverpool, Havre, and Bremen exchanges on behalf of Americans. Should these foreign exchanges readjust their affairs to conform to the new law, the sending of messages for the execution of orders for the sale of cotton will not be subject to the tax.

I

It is not necessary to discuss here the purely academic question of the value of commodity exchanges, and their functions. Suffice it to say that the New York Cotton Exchange, like all other exchanges, is useful, that operations upon it are for the most part of a legitimate speculative character, and that such speculative transactions are not gambling.[1] It is generally recognized that the function of speculation is to relieve trade of the risk of fluctuating values by providing a class always ready to take or deliver a property at the market price, and in so doing to direct commodities to the most advantageous uses by fixing for commodities comparative prices for delivery at different times and places.

The chief service rendered by the cotton exchange is that of providing the necessary machinery for "hedging," which is availed of to a large extent by cotton merchants and spinners. "Hedging" is in the nature of insurance or protection against losses occasioned by price fluctuations. A cotton merchant in the South makes a contract in July to deliver to a New England spinner 10,000 bales of cotton in January at 8 cents a pound, a figure representing the

[1] Professor H. C. Emery, in his book on *Speculation on the Stock and Produce Exchanges of the United States*, explains the distinction between gambling and speculation, as follows: "Gambling is a transaction in which one party pays over a sum of money from his own wealth because of the occurrence of a chance event. Speculation is a transaction in which one acquires by purchase the right to a certain property (not specifically designated perhaps) and gains (or loses) for himself the difference between the value of the property at the time of the sale and its value at the time of purchase. The difference is a significant one. In gambling one party must lose just what the other wins. In speculation this is not necessarily so. A dealer in wheat may buy of a farmer and sell to a speculator, and the wheat be sold at a constantly rising price through a line of speculators, till bought by a miller for grinding at the highest price of all. Neither the dealer nor the miller loses by the transaction, which is not speculative on their part, yet each speculator in turn wins. The reason is that there has been an actual increase in value. The gains of the speculators result from the division among them of this increase. . . . . How much of such business is desirable, how far it is marked by the same spirit as gambling, are questions not raised at this point. We shall not hesitate to speak of some transactions in general terms as of a gambling nature, and yet it is well to keep clear this objective and economic distinction between gambling and speculation. Both depend on uncertainties; but whereas gambling consists in placing money on artificially created risks of some fortuitous event, speculation consists in assuming the inevitable economic risks of changes in value" (pp. 100, 101).

price at which the merchant expects to be able to buy the cotton, plus an allowance for his expenses and his profit. To protect himself the merchant buys on the exchange a future contract for 10,000 bales of cotton deliverable in January. If, by the time he makes his delivery to the spinner, the price of cotton has advanced to 10 cents, he loses 2 cents a pound based on the contract price. On the other hand, he is reimbursed for the loss by the corresponding advance to 10 cents in his January future contract. He, therefore, sells out his future contract, at a profit sufficient to offset the loss suffered on his transaction in spot cotton. If, on the other hand, the price of cotton in the open market declines, it is expected that the price of future contracts will likewise go down in sympathy. In such a case, the merchant would sell out his future contract at a loss, and buy in his actual cotton in the spot market at a correspondingly lower price than he had calculated. In this way, the profit on the spot transaction will counterbalance the loss on the future transaction.

The hedging practice is resorted to by spinners and manufacturers of cotton goods. Suppose a manufacturer makes a contract for the sale of his product for future delivery. He buys the actual raw cotton as his needs demand, and at the same time to protect himself he buys futures on the exchange. If the price of cotton goes up before he has filled his order for cotton goods, his loss is covered by profits on the futures purchased; and on the other hand, if the price of the staple declines, the loss on the futures is covered by a saving on the purchase of actual cotton.

Some banks in this country and in England refuse to lend money on cotton which is not hedged. In cases where a bank becomes the owner of a lot of cotton, through the default of some borrower, the bank while holding the same will invariably instruct its broker to cover it with a hedge order.

Inasmuch as the principle of hedging rests upon the assumption that prices for spot middling cotton and of basis middling contracts for the spot month will move in substantial unison, it is important that a normal parity always exist between the two. Unless there is such harmony in the movements of the two prices,

hedging operations are likely to be an unreliable "protection" against losses resulting from fluctuations.

It is believed that under the new law, with a more just system of fixing differences, this parity will be more uniformly maintained. If the grade differences are at all times kept at exactly the commercial differences prevailing in spot markets, the price of basis contracts for the current or spot month should rule very close to the spot price of middling cotton.

II

Notwithstanding the fact that the New York Cotton Exchange has always occupied a pre-eminent position as a national agency for the marketing and distribution of the American cotton crop, its by-laws and rules governing transactions have not been fair to the various interests which were obliged to do business on the exchange and to rely upon its quotations. The principal provisions of the contract traded in on the New York Exchange concern, first, the grades of cotton which may be delivered, and secondly, the adjustment of the differences for the relative values of the several grades that are tendered for delivery. In both of these particulars, the New York Cotton Exchange contract had been faulty: it permitted delivery of cotton that the buyer could not use—which, though "merchantable," was not available for mill requirements; and secondly, it sanctioned a method for arriving at the differences in the value of the various grades which was arbitrary, uncommercial, and palpably unfair. The combination of these two features of the contract made operations on the New York Exchange objectionable and very properly called forth a widespread demand for reform. Besides these objections, the standard classification used on the New York Exchange was different from that used in other markets and though the names of the grades were the same, they denoted dissimilar qualities. This lack of uniformity inevitably resulted in great confusion, and not infrequently cotton merchants suffered financial losses, through ignorance or from deception.

The New York Exchange, for over forty years, has adhered consistently to the standards fixed by a committee of experts appointed at a meeting of the National Cotton Exchange, held in Augusta, Georgia, in June, 1874.[1] Liverpool has its own standards for American cotton. Up to the time of the adoption of the Cotton Futures act, Atlanta had a different set of standards, and so had Augusta. Savannah traded on Liverpool grades, using Liverpool middling as a basis. Atlanta middling was equal to Liverpool good middling. Prior to the universal adoption of the government standards, the same grade name was applied to two qualities differing in market value by as much as $2.50 a bale. Under this condition of affairs it was difficult for the grower to know the value of his product on markets other than his own.

For years prior to the passage of the Cotton Futures act, both the New York and the New Orleans exchanges classified cotton into a large number of grades—at one time as many as 30—the classification being based chiefly on color and the amount of dirt and trash contained in the cotton. On the New York Exchange the classification of contract cotton is conducted by an inspection bureau composed of salaried employees of the Exchange who examine the cotton and issue certificates of grade. In New Orleans, the classification is left to arbitrators, who determine the relative value of the cotton tendered, using middling as a basis. In the past, criticism has been directed against the New York classification on the ground that the New York by-laws did not provide for the rejection of weak or "perished" staple cotton, delivery of which was excluded by the New Orleans Exchange. It was also repeatedly charged that there had been considerable over-classification or over-grading. Inasmuch as the buyer of a contract must accept whatever cotton the seller chooses to deliver to him, it is evident why spinners found it undesirable and hazardous to buy cotton on the exchange: they did not want to place themselves in a position where they would be obliged to accept cotton of various grades,

[1] John T. Doswell, of New Orleans, was chairman of the committee which comprised fourteen members from cotton-producing centers and four members from other cotton exchanges not in the cotton belt. The committee met in New York on August 31, 1874, and adopted on that date, effective the following October, the grades of cotton used by the New York Exchange ever since.

including exceptionally low ones, many of which they could not possibly utilize in the manufacture of cotton goods. Moreover, under the old system, the seller, in giving notice of delivery, did not inform the buyer of the grades of cotton he expected to deliver.

The most serious charge made against the New York Cotton Exchange was that of arbitrarily fixing the differences for the relative values of the various grades of cotton deliverable on contract. Trading is done on the basis of middling, and there have been from 10 to 15 grades above and below this basic grade. The seller of 100 bales, according to the by-laws of the Exchange, had the right to deliver any and all grades of cotton, and the buyer had no option. The prices of the various kinds of cotton within the prescribed range of grades was determined by the so-called "differences" above and below, or "on" and "off" middling. For the last eighteen years the New York Exchange has used the "fixed-difference" system, that is, a committee of the Exchange would meet twice or three times a year, at stated dates, and arbitrarily decide the scale of differences. This body of men, called the Revision Committee, was not bound by any rules of procedure, nor was it restricted to any definite method for arriving at the relative values. It had full discretionary power and could avail itself of any or no information upon which to base its decision. Until recently the committee met only twice a year, in September and in November; but a few years ago, a day in the month of February was added as a third revision period. For about a year past the revisions have been monthly.

The evil of the system lay in the fact that the fixed differences frequently did not represent the actual relative market values of the different grades of cotton. Particular spinners require particular grades of cotton for their mills, some using the lower grades and some requiring the better qualities. The price of any particular grade is dependent in a measure upon the demand and supply of that grade. The supply of the different grades is never uniform in volume, the weather being an important factor. During certain seasons there is usually a greater supply of the more desirable or higher grades and a lesser supply of the lower grades. When the supply of either one of these two divisions is excessive, the law of

supply and demand is supposed to reflect this, but under the fixed-difference system it did not always do so. The result was that there was attracted to New York a large quantity of low-grade cotton which was stored in warehouses and used as stock for delivery in settlement of outstanding contracts. Frequently when a spinner received delivery of some of the low-grade cotton which did not suit his mill requirements, he found that if he tried to sell the cotton in the spot market, he would lose considerable money for the actual commercial value was far below that of the fixed value arbitrarily established by the Revision Committee months in advance.

Herbert Knox Smith, commissioner of corporations, in his report[1] on cotton exchanges, says:

Fixed differences are an attempt substantially to render future transactions a "sure thing" for a limited class of speculative experts. The system amounts to an attempt absolutely to fix prices—an economic absurdity. The relative values of different grades are as much subject to the natural laws of supply and demand as the value of middling cotton itself, and it is as unreasonable to attempt to fix one by the fiat of a committee as it is the other.

The result of this attempt is to affect the basis price that is paid for future contracts. The law of supply and demand, unable to work directly on these fixed differences, works itself out indirectly on the basis price of the contract; but this indirect action results in great loss to a vast body of persons who are not experts and who do not understand this artificial machinery or its results. By compelling operators in futures to consider probable conflicts between the two sets of differences, as well as possible variations in the price of middling cotton itself, an unnecessary increase in trading risks is introduced. This is clearly an evil. The system results in shifting the burden of risk from a limited class of experts to a non-speculative class, or to those ignorant of the working of the system. A premium is thus put on intelligence applied to artificial conditions, which of course is of no service to the public, rather than on intelligence applied solely to forecasting the actual conditions of supply and demand. In the same way, the system tends to shift the burden of risk from sellers upon buyers. Clearly a great advantage is given the seller from the fact that he can offer on contract any grade he chooses. He should not have both this privilege and the privilege of arbitrarily fixed differences, which almost invariably overvalue certain grades. The result of the combination of the two is to give the seller an extremely unfair advantage over the buyer.

The foregoing criticisms were strikingly illustrated in November, 1906, as the result of the failure of the New York Revision Committee to establish

[1] Part I, May 4, 1908.

correct differences. Owing to abnormal weather conditions, the commercial values of the lower grades of cotton fell very sharply from the price of middling. The Revision Committee failed to adjust its "fixed" differences to the actual situation and established differences for low grades which very heavily overvalued them. As a result the future contract price at New York dropped abruptly from the price of spot middling, to the tremendous loss of a vast number of holders of future contracts for cotton and the profit of the few experts who understood and anticipated the effect of the system. Hundreds of men also, who had hedged cotton by buying contracts in New York, were injured by this striking disturbance in the parity. A number of failures in the South were charged to this one cause alone. One result has been to reduce hedging in New York, as the possibilities of its artificial system were thus disclosed.

As pointed out above, such a disastrous disturbance in the parity is exactly what is brought about by the errors in the fixed differences in New York.

The reply of certain interests in the New York Exchange is that "a contract is a contract"; that men who deal there come of their own will and are supposed to understand the game. This position cannot commend itself as sound business ethics. Practically, also, it is not true that cotton interests are wholly at liberty to stay out of the exchange. As shown above, certain interests must have a hedging place. Furthermore, financial connections with New York are so close that New York must be that place for many of them. Still further, the New York Cotton Exchange practically owes its existence to the volume of business made possible by the participation of outside interests. Both the duty of a private business man to his customers and the duty of a concern which is to a certain extent a public utility demand fair dealing.

The injury from such errors in differences as are inevitable under the fixed-difference system is not, however, the limit of possible harm under that system. There is danger that improper differences may be intentionally established.

As stated above, differences are fixed in New York by the Revision Committee but twice a year. The New York Exchange does not, as does New Orleans, provide any standard by which the committee shall act. It is not obliged to follow the spot-market quotations, or even any general principle. This leaves it an extreme degree of arbitrary power. This committee is usually made up of men who are large operators on the exchange, and who are constantly interested in the future market. It is within their power so to fix these differences as to affect enormously the value of their own future contracts. In this same revision of November, 1906, when the differences fixed by the committee were radically wrong, several members of this committee have admitted that they were at the time heavily interested in future contracts, and that they profited by the action of the committee. There is no conclusive proof that they intended this. It is sufficient to point out that this fixed-difference system, applied thus arbitrarily by a small body of men, furnished in this case a condition where (1) these men had the power thus to reap enormous profits at the expense of others; (2) they admit that they did reap profits;

and (3) the motive for doing so was extremely strong. Comment upon this situation is hardly necessary. . . . .

The present New York system of fixed differences is uneconomic, in defiance of natural law, unfair, and, like all other attempts to defy natural law, results in such complex and devious effects that the benefit of its transactions accrues only to a skilled few.

III

The unfair methods of the New York Cotton Exchange aroused dissatisfaction and antagonism on the part of cotton-growers and spinners, who sought to remedy conditions by legislative enactment. The exchange has been the subject of constant attack in and out of Congress for a great many years. In political tradition it has been as iniquitous as the so-called "Money Trust." With southern statesmen it has been a favorite theme. Nothing appealed more to a southern constituency than a promise to annihilate the Exchange which "robbed" the poor farmers of their cotton. If quotations for cotton were low, the New York Exchange was blamed for depressing prices and impoverishing the planter; if quotations were high, members of the Exchange were accused of trying to corner the market.[1]

[1] It is interesting to note that twenty-three years ago, Edward Douglass White, then United States senator from Louisiana, and now chief justice of the United States Supreme Court, delivered a notable address on the floor of the Senate in opposition to a pending bill which provided for the imposition of a license tax on brokers and a tax of 5 cents a pound on future sales of "raw or unmanufactured cotton, hops, pork, lard, or bacon; and the sum of 20 cents per bushel for each and every bushel of any of the other articles mentioned in section 3 of this act." In that bill a future contract was defined as one made by a person who was not the owner of the articles contracted for, to be delivered at a future date. This clause of the bill was limited by exempting future contracts made by the government and certain contracts made by farmers and others. In the Senate speech on July 21, 1892, Justice White said: "I should hesitate very much with this knowledge to make any very elaborate discussion as to the constitutionality of the bill, or as to the wisdom of the legislation which it propounds, if I were not profoundly conscious that in my judgment there has been before the American Congress for many years no more pernicious, no more vicious, no more flagrantly unconstitutional legislation, no legislation more tending to undermine and destroy the very foundations of our government, and none more calculated to do untold and untellable harm to the people of this great country. The interests which this proposed legislation affect are enormous. The products, the price or sale of which the bill attempts to regulate, run up into vast proportions. . . . .

"There cannot be any question that the contract which the bill strikes at in its second section is a lawful contract, that is removed beyond the domain of controversy. The question has been before every court in this land. It has been to the Supreme

Members of Congress may be divided into three classes in respect to cotton futures legislation: first, those who have insisted in season and out of season that the New York Cotton Exchange should be forced to close its doors and remain closed; secondly, those who have advocated intelligent reforms in practice and federal supervision within reasonable limits; and, thirdly, a contingent which took no interest in the subject at all, or was interested in it only to the extent that it supplied attractive campaign material.

Much of the criticism directed against the Exchange was unintelligent and general in character. The loose characterization of the members of the Exchange as "gamblers," and the insistence upon an entire abolition of exchanges indicate the trend of opinion which was shared by a large part of the public and was translated into action in the halls of Congress by the introduction of bills prohibiting transactions in contracts for the future delivery of cotton. A great many such anti-option bills[1] were introduced. The apparent ignorance on the part of our legislators of the functions of exchanges and the economic soundness and legitimacy of transactions in "futures" was astounding and has at various times suggested the need of educational work. The agitation against exchanges, although principally directed against cotton trading, applied in a measure to transactions in wheat and corn. Parenthetically, it may be noted that this agitation was not entirely

Court of the United States; it has been to the courts of last resort of almost every state in this Union, and it has been crystallized in a body of jurisprudence now passed beyond question that it is absolutely as lawful for a man to sell for future delivery as it is to sell for present delivery; that there is no earthly difference between the two; that they are both valid contracts protected by the law, enforced by the courts; provided only that either of the parties to the contract has an honest intention to deliver.

"The purpose, then, of this bill is to strike down contracts which can be validly entered into; protected by the judgments of the courts of last resort of all this Union. I challenge any senator upon this floor to produce a single modern authority which does not recognize that the right to make these contracts under the dominion and jurisdiction of the state courts is as absolutely sacred and as well protected by the aegis of the state law as his right to hold his home, or any other right that he has within the dominion of the state."

[1] The following from H.R. 9676 (December, 1913) is illustrative of bills that have been introduced from time to time: "That any person or persons who buys or sells 'cotton futures' with no intention of having actual cotton delivered shall be deemed guilty of keeping and running a gambling-house, and shall be fined not less than $5,000 for each conviction."

confined to the United States, but was in evidence in Europe, where the German agrarian interests, at a time when they were particularly influential, succeeded in having future trading in grain stopped for a short period, only to find the great error they had committed.

While this agitation against the Cotton Exchange was going on, there appeared a comprehensive report[1] on the exchanges, submitted by Herbert Knox Smith, commissioner of corporations, in response to a resolution[2] of the House of Representatives, adopted on February 4, 1907. This document went very thoroughly into the methods of exchange operations, and in a sober way pointed out the evils of the then existing system. The two chief recommendations for reform made by the Bureau of Corporations—namely, the adoption of government standards and the use of a commercial difference system for establishing relative values of the different grades—are the salient features of the cotton law under consideration.

Following the publication of Commissioner Smith's report, every session of Congress witnessed the introduction of one or more measures directed against the Cotton Exchange. These periodic anti-option bills, although they caused temporary apprehension in cotton circles, never received very serious consideration. The most important step in the legislative movement, prior to the enactment of the Cotton Futures law, was the so-called Clarke amendment to the Underwood-Simmons tariff bill of 1913.[3] This amendment, described as a "rider" attached to the tariff bill by the Democratic caucus in the Senate, provided for the imposition of a tax

[1] *Cotton Exchanges*, Part I, May 4, 1908; Parts II and III, May 29, 1908; and Parts IV and V, December 6, 1909.

[2] The resolution, No. 795, reads as follows: "*Resolved*, That the Secretary of Commerce and Labor, through the Bureau of Corporations, be, and is hereby, requested to investigate the causes of the fluctuations in the price of cotton and the difference in the market price of the various classes of cotton, and said investigation shall be conducted with the particular object of ascertaining whether or not said fluctuations in the prices have resulted in whole or in part from the character of contracts and deliveries thereon made on the cotton exchanges dealing in futures or is the result of any combinations or conspiracy which interferes or hinders commerce among the several states and territories or with foreign countries."

[3] H.R. 3321, 63d Congress, 1st session.

of one-tenth of one cent per pound on cotton traded in for future delivery, the same to be returned to the taxpayer in the event the cotton was "actually delivered." Heavy penalties were imposed for violations of the law. The report[1] of the Senate Finance Committee expressed the opinion that the government would derive a revenue of approximately $7,000,000.00 from taxing cotton futures. It essayed the estimate that only 10 per cent of the total transactions on the exchange represented legitimate "hedging" and that the balance of 90 per cent was purely speculative.

The Clarke amendment was objected to upon a number of grounds: first, that it had no place in a tariff bill; secondly, that, if enacted, it would not do away with speculation, but merely shift transactions from New York and New Orleans to Liverpool and Bremen; thirdly, that it would hurt the cotton-producer more than the exchange broker, by diminishing the market for his supplies; fourthly, that it would practically put all the exchanges (distributing centers) out of business; fifthly, that it would add to the price of cotton which the consumer would have to pay in the

[1] Commenting on the Clarke amendment, the report of the committee says: "The tax imposed by the committee is deemed to be sufficiently small to make its payment justifiable by those who resort to the exchanges for the purpose of hedging and sufficiently large to deter the activities of those who resort to such exchanges for the sole purpose of speculation and gambling in the differences of price created from time to time by fluctuations frequently artificially produced.

"The committee believes the subject-matter to be one fit for the imposition of a proper tax, not only because of its indirect influence in eliminating a parasite which has afflicted the business of dealing in purchases of cotton for future delivery, but because it will result in the collection of a considerable sum of revenue from a source which in its usual operation produced abnormal profits from a business that is not susceptible of just taxation in any other way. The committee is advised that since 1907 no official record of the extent of the dealings on the cotton exchanges in contracts for future delivery is accessible to the public, but reliable estimates fix these dealings at about 130,000,000 bales annually in recent years. It seems to be the consensus of opinion that about 10 per cent of the contracts of sale and purchase of cotton for future delivery is embraced in that branch of the business known as hedging, and that the other 90 per cent thereof is of a speculative or gambling character, where no delivery of the product is ever really intended to be made. If the effect of the proposed tax is to eliminate all of the latter class of business and to leave intact that part of the dealings resorted to for hedging purposes, the revenue derived from this tax should amount to about $7,000,000.00 a year, and if its imposition does not have the effect of eliminating the gambling or speculative end of the business the revenue derived therefrom will be enormously in excess of this amount."

long run; and sixthly, that the revenue derived from the proposed tax would be practically negligible. It was also pointed out that if Congress passed the Clarke amendment, and American cotton exchanges were discontinued, the United States would be left without any primary or determining market, all of the forces of supply and demand being focused in some foreign market—probably Liverpool. Under those circumstances, it was asserted, the great majority of American cotton merchants would labor under the double disadvantage of neither being able to "hedge" nor having a primary cotton market for their guidance, in consequence of which they would speedily lose the banking credit which enables them to make a very large turn-over compared with the fixed capital invested.[1]

With the exception of the Cotton Futures act as finally adopted, and the Clarke amendment to the tariff bill, practically all of the previous measures introduced in Congress sought to regulate cotton exchanges by restricting the use of the mails, telegraph, and telephone for the transmission of messages for the sale of cotton for future delivery. The constitutional provision empowering Congress "to establish post-offices and post roads"[2] was similarly invoked in the bills prepared by Samuel Untermyer, counsel to the so-called "Money Trust" Committee of the House. The constitutionality of using this device has been seriously questioned, although the Supreme Court of the United States refused to declare invalid the newspaper publicity law,[3] requiring news-

[1] See pamphlet on *The Cost of a Prohibitive Tax on Cotton Future Contracts*, by Arthur Richmond Marsh, formerly president of the New York Cotton Exchange.

The prohibition of trading in cotton futures—that is what the Clarke amendment virtually amounted to—recalls that just about half a century ago Congress passed an act forbidding all sales of gold and foreign exchange on "time" contracts. That act closed up the "Gold Exchange" which was located in William Street, New York City, but the results were so serious that nineteen days later Congress repealed the law. The law prohibiting trades in "gold futures" was passed on June 17, 1864. It was responsible for a big rise in the premium for gold. Quotations for $1.00 in gold were at one time $2.20 to $2.90 in greenbacks. Congress repealed the act on July 6, 1864. A. Barton Hepburn, in his book on *History of Coinage and Currency in the United States and the Perennial Contest for Sound Money*, says: "This short period (nineteen days) sufficed to convince Congress of the futility of attempting to regulate the premium upon gold by legislation."

[2] Sec. 8 of Article I.

[3] 37 U.S. Statutes at Large, pp. 553, 554.

papers and periodicals to print the circulation and the names of the owners of publications. Although a great many bills providing for postal regulation have been introduced, the newspaper law is the only one that has been placed upon the federal statute books. In the newspaper case,[1] the United States Supreme Court very resolutely refrained from upholding the plenary power of Congress to regulate the use of the mails as it will, and rested its decision upon the privilege enjoyed by newspapers of being charged a lower rate of postage than other mail. Chief Justice White, in closing the opinion, said most significantly: "Finally, because there has developed no necessity of passing on the question, we do not wish even by the remotest implication to be regarded as assenting to the broad contentions concerning the existence of arbitrary power through the classification of the mails or by way of condition, embodied in the proposition of the government which we have previously stated."

The framers of the Cotton Futures act, realizing the doubtful efficacy of postal regulation, sought to accomplish their purpose by imposing a prohibitive tax for non-compliance with government prescriptions for doing business in cotton. The United States Supreme Court, notably in the oleomargarine case,[2] has upheld the constitutionality of an act wherein the federal government's right to impose taxes was used not for the purpose of increasing its revenue but for the accomplishment of a certain performance on the part of its citizens.

IV

In the years following the publication of the report of Herbert Knox Smith, while officials in Washington were endeavoring to bring about the adoption of government standards of grade and the substitution of the commercial system for fixing differences between grades, the New York Cotton Exchange authorities vigorously combated all efforts to coerce it into making changes, and each and every bill introduced was fought aggressively by the leading members of the Exchange, who made it a practice to appear

[1] *Lewis Publishing Co.* v. *Morgan* (229 U.S. 288).

[2] *McCray* v. *United States* (195 U.S. 27).

before the Senate and House committees whenever any hearings were scheduled on bills relating to cotton futures. Arguments and speeches in defense of the New York Exchange were made, not only in Washington, but at all meetings of cotton manufacturers' associations, where an attack upon the New York contract was a regular feature of the proceedings.

Criticism became so common and persistent that after four years of fighting (1909–13), the Exchange authorities realized that the forces arrayed against them were gaining in power and that eventually legislation would be enacted, despite all efforts made to prevent it. In other words, rapid developments plainly indicated that the Exchange would have to meet the demands of the situation, and sooner or later yield to the progressive tendencies of the times as manifested by the widespread movement for the regulation of business methods and enterprises, fostered with the view of placing all business on a more nearly honest and equitable basis.

This four-year period developed a considerable number of "progressives" among the membership of the New York Cotton Exchange—brokers differing in their opinions from the old reactionaries, who could not and would not see anything wrong in any of the by-laws and rules of the Exchange, and who steadfastly adhered to the belief that the New York Cotton Exchange had long ago attained absolute perfection as a future market. This so-called progressive element finally succeeded in directing the Exchange's attention to the "writing on the wall," and to the wisdom of bringing about reforms from within rather than having to submit to reformation at the hands of Congress. After considerable procrastination and yielding to pressure exerted by the younger members, the board of managers of the Exchange on October 2, 1913, appointed a special committee to consider the question of changing the then existing standards and for the purpose of determining whether or not any revision should be made of the by-laws and rules. This committee labored for seven weeks, holding almost daily conferences, and then submitted an elaborate report to the board, which gave it careful consideration. On November 21, 1913, the board announced that it had finally decided to adopt the government standards and to make a revision of the differences monthly,

instead of only two or three times a year. Incidentally, the board recommended a change in the rules restricting the extension of credits to persons, firms, and corporations actively engaged in the cotton trade. This measure was apparently decided upon for the purpose of showing Congress that the Exchange was discouraging "speculation" in cotton by those not directly connected with the business, who used the Exchange for other than "hedging" purposes. The committee, in its report to the board of managers, suggested that representations be made to the Washington authorities with the view of bringing about, if possible, the substitution of the international types in place of the government standards. The report stated that in the event this effort of the Exchange did not bear fruit by April 1, 1914, the Exchange should adopt the government grades.

The board of managers, at a meeting held March 17, 1914, adopted the government standards, the change going into effect on contracts maturing on and after April 1, 1915. It was generally realized that existing contracts could not be altered, and that the old methods of trading would have to be continued until the current contracts matured. It was therefore decided to inaugurate trading in contracts based on government standards and monthly revisions at a date earlier than April 1, 1915. This was done by the institution of trading in two forms of contract, designated as the "new" and the "old."

V

The United States Cotton Futures act has done away with the abuses that had previously existed by compelling, first, the adoption of a uniform set of standard grades, secondly, the exclusion from deliveries of cotton of inferior quality and of very short staple, and thirdly, the adjustment of differences in value of the various grades in a commercial way by requiring that the figures be based on prices actually paid for the different grades at the several cotton markets of the country. It is interesting to note that the law follows rather closely the recommendations made by the Commissioner of Corporations seven years ago.

The desirability of having a single uniform standard classification for American cotton is manifest. The application of one

uniform standard will necessarily result in a greater simplification of all cotton transactions, doing away with the complex method of figuring buyers' limits. The local buyer usually knows the market cotton grades, while the farmer does not.[1] Not infrequently, the buyer secures cotton at practically a flat-rate basis on lower grades, grades the cotton himself, and sells it for what it is worth. The middleman profits from this transaction, while the producer receives less than he is entitled to.

For the purpose of having the Department of Agriculture undertake systematic work in cotton standardization,[2] Congress provided for the expenditure of necessary funds in an act passed in February, 1909. This act gave the department authority to establish an official standard for the nine grades of American cotton. To aid in the work, the Secretary of Agriculture called together a committee of nine men, prominent in various branches of the cotton trade, with three experienced classers, from the New York, New Orleans, and Dallas exchanges. The committee prepared the official grades which were subsequently approved by the Secretary, but their adoption and use was voluntary. These permissive standards never came into general commercial use, principally because the standards for the low grades were typical of an insufficient proportion of the low grades of the eastern part of the cotton belt. The generally expressed opinion of the trade was that the lower grades were "too full," and that the cotton used in the original standards for these grades was of a brighter color than occurs in these grades east of the Mississippi River. The official grades being considered higher or "fuller" than any previously recognized by the trade, the spinning interests of the country made a concerted effort to make them the basis of their purchases. Shippers from the Southeast, however, found it necessary to qualify their offers of low grades by the frank statement that they could not match the color of the official standard for those grades.

[1] Charles J. Brand, in charge of the Office of Markets of the Department of Agriculture, had a survey made of the primary markets in Oklahoma in the season of 1913. He found that on the same day and at the same point the lower grades of cotton very often sold for better prices than did the higher grades, and vice versa.

[2] "The Classification and Grading of Cotton," by D. E. Earle, cotton technologist, and W. S. Dean, assistant in agricultural technology (*U.S. Department of Agriculture Farmers' Bulletin No. 591*, July 10, 1914).

A majority of the organized spot markets of the country formally adopted the permissive official grades, but field investigations of the Department of Agriculture showed that they were made the basis of a comparatively small part of the business between established cotton merchants in the South and their American and foreign customers. The net result, therefore, of the issuance of these standards, prior to the passage of the Smith-Lever law, so far as the actual trade in spot cotton was concerned, was to add one more standard of classification to the numerous standards already in use.

During the three years that these official grades were before the public, it became evident that the cotton trade of this country was not likely voluntarily to unite in their use, while the action of the American and European cotton exchanges at Liverpool, June 2 and 3, 1913, in preparing and recommending to the trade of the world a new international standard which differed widely from our permissive official grades, showed plainly that the latter would never be acceptable as a universal standard. The action taken at Liverpool was followed by the adoption of a resolution in May, 1914, by a convention assembled at Augusta, Georgia, at which nearly all the exchanges of this country were represented, asking the Department of Agriculture to adopt the proposed international standards. This action was equivalent to an expression of opinion that the permissive standards, previously issued as official, were unsuited to universal use. The department was inclined to share this opinion and believed it unwise to attempt to secure general adoption of a standard which was more exacting than those of the great foreign consuming markets, or to enforce such a standard upon our domestic cotton industry.

The management of the New York Cotton Exchange refused to be forced into the adoption of these permissive government standards for two reasons: first, because the standards were made of cotton from Memphis, New Orleans, and Texas only, and no standard had been made for upland or Atlantic states cotton, which is the basis of all spot quotations the world over, wherever cotton is quoted and wherever cotton is traded in for delivery against future contracts on the basis of middling. The other reason was

that in making the standards the committee of experts, in order to produce as close a correspondence as possible between domestic and export grades, not in name but in type, and thus to prevent any confusion throughout the cotton belt by changing the grades, raised the basis grade middling slightly above the New York middling grade, and in working down for each half-grade until good ordinary was reached eliminated the good ordinary American standard classification as used by the New York Cotton Exchange, thereby leaving without any standardization a grade of cotton readily spinnable and having a distinctive value as compared to middling.

When the time arrived for the Department of Agriculture to promulgate standards under the Cotton Futures act of 1914, the old permissive standards of 1909 were practically discarded. The department had in hand a great wealth of material for purposes of comparison and type-making. The proposed international standard was considered, but was found to contain certain tinged samples which precluded their use, inasmuch as the act contemplates separate types for tinged and stained cotton. The department secured the temporary services of some of the best classers on the New York and New Orleans exchanges to assist its technical force in perfecting a standard which should meet the valid objections to the old official grades and yet avoid the introduction of anything which should be classed as tinged or spotted cotton. The result of the combined labors was a set of standards believed to represent the white cotton of an average American crop more closely than any standard previously prepared.

As a test of the extent to which this standard differed from the official grades, several thousand bales of low-grade cotton which had been classed on the old official grades were reclassed by the same men against the new standard, and it appeared from the result that about 12 per cent more of the cotton crop can be classed by the new official cotton standards of the United States than by the old official grades. The Secretary of Agriculture, therefore, promulgated these standards for the nine grades of cotton: Middling Fair, Strict Good Middling, Good Middling, Strict Middling, Middling, Strict Low Middling, Low Middling, Strict Good Ordinary, and Good Ordinary.

The Cotton Futures act abolished the fixed-difference system by requiring the exchange to determine, almost daily, the differences between grades by taking the average of the quotations sent in from certain spot markets designated by the Secretary of Agriculture. Since the law became operative on February 18, the Secretary has named the following markets: Augusta, Boston, Dallas, Houston, Little Rock, Memphis, Montgomery, Norfolk, and Savannah. Fall River, Massachusetts, was originally named but was later withdrawn because no quotations were obtainable.

TABLE I

Grade	New York Standard January 28 Cents	Government Standard January 25 Cents	Government Standard Revision under New Law February 19 Cents
Middling fair	1.10 on	1.05 on	1.06 on
Strict good middling	.90 on	.76 on	.82 on
Fully good middling	.75 on	.63 on	...
Good middling	.60 on	.50 on	.55 on
Barely good middling	.45 on	.39 on	...
Strict middling	.30 on	.28 on	.27 on
Fully middling	.15 on	.14 on	...
Middling	Basis	Basis	Basis
Barely middling	.22 off	.16 off	...
Strict low middling	.44 off	.32 off	.45 off
Fully low middling	.77 off	.58 off	...
Low middling	1.10 off	.85 off	.99 off
Strict good ordinary	1.78 off	1.50 off	1.54 off
Good ordinary	...	2.00 off	2.04 off
Strict good middling tinged	.30 on	.42 on	...
Good middling tinged	*...	.17 on	...
Strict middling tinged	.20 off	.05 off	...
Middling tinged	.40 off	.32 off	...
Strict low middling tinged	1.25 off	.92 off	...
Low middling tinged	...	1.50 off	...
Middling stained	1.25 off	1.00 off	...

* Value of middling.

The New York Cotton Exchange made its first revision under the new law on February 19, the announced differences being applicable for deliveries on February 26. The differences announced on that day showed only a slight variation from the grade differences fixed by the committee on January 25—the revision on that date being determined by the old method of having the committee fix the scale of differences by exercising its discretion as to the relative values of the various grades.

Table I gives a comparison of (1) the latest differences governing "old-style" contracts, New York standard, dated January 28; (2) the differences applying to February "new style" contracts, government standards, No. 452, dated January 25; and (3) the new differences adjusted on February 19, in accordance with the Smith-Lever law.

At various times, the suggestion has been made that the scale of differences be determined according to the relative spinning values of the various grades. Experiments for the determination of these values have been made by private interests and by the government,[1] but thus far this method for the establishment of differences has not been found practical. The purpose of ascertaining the "spinning values" of different grades of cotton is to show the producer what his cotton is intrinsically worth, so that he may not sacrifice his apparently poor cotton, which looks so only to the eyes of the uninitiated.

VI

The chief criticism directed against the Cotton Futures act is that the operation of sec. 11 relating to the transmission of orders to foreign exchanges practically puts a stop to hedging in foreign markets, and to arbitrage transactions.

Under the law, any European may trade on the New York or New Orleans Cotton Exchange, but no American can buy or sell American cotton for future delivery in Europe without paying a tax of 2 cents per pound, or about $1,000.00 on each 100 bales. An American can buy or sell Egyptian, Peruvian, or East Indian cotton for future delivery anywhere, but he must not buy or sell the product of American cotton fields in Europe without paying this tax.

It is desirable that forward sales of cotton be hedged in the market where delivery is to be made. In the case of exports to Europe, a foreign hedge serves in a measure as an insurance against ocean freight rates, marine and war-risk insurance, and fluctua-

[1] "Tests of the Waste, Tensile Strength, and Bleaching Qualities of the Different Grades of Cotton as Standardized by the United States Government," by Dr. N. A. Cobb, agricultural technologist (*U.S. Department of Agriculture Bulletin No. 62*, January 14, 1914).

tions in foreign exchange. A contract made before the war for delivery to an English spinner of 100 bales of middling cotton in March, and hedged by a purchase of contracts in Liverpool, would show only a nominal difference, profit or loss, to complete the transaction. The same contract hedged in New York would show a heavy loss. The increase in freight rates, etc., since the outbreak of the war amounts to about $20 a bale—a difference which would not be reflected in a hedge made in New York.

In order to exempt from taxation the transmission of orders for the sale of cotton on the Liverpool Exchange, it will be necessary for the Liverpool Cotton Association to adopt the American government's standard grades for cotton, and to change its methods of doing business to conform to the provisions of the act. Last year, the government sent over several representatives to Liverpool for the purpose of making representations to Liverpool cotton dealers, calculated to result in the adoption of the government standards. The report of the delegation made to the Secretary of Agriculture has not yet been published, but it is understood that the Liverpool authorities indicated no disposition to alter their business practices.

It is understood that the Bremen Cotton Exchange will adopt the American standards after the war. A cotton exchange is being organized in Rotterdam, and it is reported that its business will be conducted in accordance with the Cotton Futures act, so that cotton merchants in the United States will be able to trade there without being obliged to pay the prohibitive tax.

The advantage of foreign houses over American concerns may be illustrated in the following way: An American firm desiring to hedge in Liverpool cannot do so without paying the tax, which, being prohibitive, is a bar to such transactions. The European house, having a representative located in the spot markets in the South, may require him to cable daily reports of his purchases. His principals abroad will use the information thus conveyed, executing a hedge against such purchases on the Liverpool market. There is nothing in the law preventing an employee from reporting to his employer, and it is only to be expected that cotton-buyers located in the South should send messages to their employers in Europe, advising them of their activities.

No such arrangement, it is asserted, may be entered into by American concerns, and it is not likely that recourse will be had to subterfuge, as the penalties for violation of the law are very severe. It is believed that the establishment of a partnership relation with a person in Liverpool, and the mutual transmission of messages regarding the operations of each of the two partners, would be construed by the government and the courts as an indirect evasion of the law.

Objection has also been made to the provision in the law restricting cotton tenderable on contract to a staple of not less than seven-eighths of an inch in length. However, this criticism does not appear to be well founded. An investigation has shown that out of about 3,000,000 bales examined only 7,050 bales, or about one-fifth of 1 per cent, consisted of a staple shorter than seven-eighths of an inch.[1] Taking into consideration all the restrictions provided in the new law, such as the elimination of perished and immature staple, it is estimated that only from 10 to 15 per cent of the cotton crop in a normal year will be untenderable on contract under the terms of the act.

VII

Like the bankers who severely attacked the Glass-Owen Currency bill and predicted all kinds of dire consequences in the event of its passage, but later became reconciled to the Federal Reserve act and now regard it as an important piece of constructive legislation, so also are the members of the New York Cotton Exchange rapidly coming to realize that the Cotton Futures act is a serviceable measure, and will benefit them as well as the cotton trade at large. From the mass of indescribable bills designed to regulate cotton exchanges that have been proposed from time to time, there has come forth a law that is moderate in tone, not destructive of the great agencies for the distribution of the country's crop, not prohibitive or restrictive of legitimate business operations—a law that is workable, fair, and just and at the same time protective

[1] See letter of Charles J. Brand, chief of the Office of Markets, Department of Agriculture, to the House Committee on Agriculture, 63d Congress, 2d session, published in record of committee's hearings on bills regulating cotton exchanges, pp. 301–4.

of the interests of the cotton-buyer and -seller, the farmer and the millman, the exporter and the spinner.

It is, of course, too early to estimate the practical results of the operation of the act, but from all indications there is reason to believe that its operation will meet with success.

The act is interesting as a historic step in the movement for governmental supervision and co-operation in the transaction of business. This country has long had an Interstate Commerce Commission for the regulation of railroads; only recently Congress passed an act creating a Trade Commission, authorized to oversee the activities of industrial corporations; and only about a year has elapsed since the enactment of the epochal banking and currency law, and the organization of the Federal Reserve Board, which exercises a unifying control over the banks of the country. We now have a Cotton Futures act, regulating trading in contracts for the future delivery of American cotton, and affording merchants facilities for having commercial disputes arbitrated by the Department of Agriculture, representing the federal government. The Tea law of 1897, standardizing teas and regulating the qualities that may and may not be brought into this country, and the National Pure Food and Drugs act of 1906 are laws of this same class. The enactment of "a pure fabric" law, in the interest of the dry-goods trade and for the protection of the general public, is being seriously considered in the legislative halls at Washington. In the not far distant future, Congress will undoubtedly pass laws governing the business of our grain exchanges, and also the private unincorporated associations which trade in securities.

I. NEWTON HOFFMANN

NEW YORK CITY